



2006
Gas Report
to the
Regulatory Flexibility
Committee of the
Indiana General
Assembly

Indiana Utility Regulatory
Commission



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EXECUTIVE SUMMARY

As has been the trend of the last few years, this past heating season proved to be an unpredictable one for the natural gas industry. The most significant events of the gas industry in the past year occurred in August and September 2005 when Hurricanes Katrina and Rita struck the Gulf region within a month of each other, causing major damage to gas rigs, gas processing plants, and off-shore pipelines which in turn caused a sharp increase in prices. Even though prices have been slowly decreasing since the events of 2005, these events have strengthened the debate as to the diversification of resources either from continued exploration for natural gas reserves or from other energy sources so as to decrease volatility in the market. As general supply and demand factors continue to play a major role in the price of gas, unpredictable events like the previously mentioned hurricanes cause havoc to the market when a large dependency is on gas coming from limited suppliers.

This past year was also filled with important regulatory matters that affected the industry. Northern Indiana Public Service Company's residential choice program was modified and extended, low-income programs remained in the spotlight, hearings were held for Citizens Gas' request for an increase in rates, the General Assembly passed a law allowing schools to combine their purchase of natural gas in order to increase purchasing power, decoupling became the hot topic issue in the industry, and federal mandates created stricter requirements for pipeline safety.

These and other issues are highlighted in the following Report. Topics to be discussed in more detail include: 1) natural gas industry overview, 2) Commission actions addressing price volatility and supply reliability, 3) other gas issues affecting Indiana, and 4) the role of the Commission's Pipeline Safety Division.

Natural Gas Industry Overview

Industry Structure

The natural gas industry of today is dramatically different from the industry less than a decade ago. The changes stem from the deregulation of the wellhead price and interstate pipeline unbundling¹. Today's major players include producers of gas; local distribution companies (LDCs); interstate pipelines; marketers; and customers or end users. Prior to deregulation of the wellhead price and unbundling, marketers and competition did not exist. Today the LDCs can serve as the middle man between the producer and the end user, providing bundled or unbundled service².

Utilities – LDCs

Typically, gas utilities separately purchase gas supply and transportation rights, rather than production or interstate pipeline facilities (they are not vertically integrated³). LDCs contract for their gas and transportation rights. Gas prices are set in the open market, while the Federal Energy Regulatory Commission (FERC) regulates the transportation rates for interstate pipelines.

Ownership and Corporate Structure

Local gas distribution companies in Indiana are either investor-owned or not-for-profit. Despite their different forms of ownership and corporate structure, investor-owned and not-for-profit utilities share the goal of providing reliable gas service at a reasonable cost. These utilities serve as resellers and transporters of gas to their retail customers.

¹ The interstate pipeline transports the natural gas, but never owns the actual commodity.

² Bundled service is when the LDC acts as the supplier and distributor of the natural gas. Unbundled service is when the LDC acts as only the distributor.

³ Vertical integration is a firm's involvement in all stages of the production of goods, from the procurement of raw materials to the sale of finished goods.

Investor-Owned Utilities

Investor-owned utilities (IOUs) are the largest sellers of natural gas to retail customers in the United States. In Indiana, there are three large IOUs providing gas service: Indiana Gas Company, Inc. (IGC or Vectren North), Northern Indiana Public Service Company (NIPSCO) and Southern Indiana Gas and Electric Company, Inc. (SIGECO or Vectren South), and 15 smaller IOUs. The three largest IOUs are owned by holding companies; NiSource is the parent of NIPSCO and Vectren is the parent of Indiana Gas and SIGECO. Two of these companies, NIPSCO and SIGECO, are combination utilities that provide electric service as well as gas service.

Not-For-Profit Utilities

Not-for-profits are incorporated organizations in which no stockholder or trustee shares in profits or losses. In addition, they are exempt from corporate income taxes. Most recently, the Commission issued a Certificate of Territorial Authority (CTA) to Valley Rural Utility Company on May 5, 2002 in Cause No. 42115. Valley Rural is organized as a not-for-profit and is now providing service to a single residential development in Dearborn County.

Municipals are organized as not-for-profit local government entities. They pay no Federal taxes or dividends, although revenue can be turned over to the general city fund in lieu of taxes if the city elects to do so. They raise capital through the issuance of tax-free bonds. There are 19 municipally owned gas utilities in Indiana, but only two are regulated by the Indiana Utility Regulatory Commission (Commission). The state's largest municipal gas utility, Citizens Gas and Coke Utility (Citizens)⁴, which serves Marion County, and Aurora Municipal Utility are

⁴ Citizens was chartered in 1887 as a Public Charitable Trust. A charitable trust is organized to serve private or public charitable purposes. A charitable trust is usually a non-profit organization which has to account for its activities (especially financial) to the government. There is normally an obligation to register a non-profitable charitable organization as the public is entitled to some oversight of organizations that wish to act for the public good. Citizens is generally treated as if it were a municipal utility.

the only two rate-regulated by the Commission. The remaining municipal utilities have “opted out” of the Commission’s jurisdiction.⁵

Function

Gas utilities may provide bundled or unbundled services. When it provides bundled services, the LDC serves as both merchant and transporter. Unbundled services are provided when the utilities fulfill only the role of transporter.

Merchants

The merchant is responsible for purchasing gas at the wellhead for resale to its customers. Usually in this scenario the LDC will provide bundled services to the end user (the LDC purchases the gas, transports it through interstate pipelines, and then distributes it to the customers).

Transporters

In some cases, the LDC only fulfills the distribution role, transporting natural gas from the city gate (the beginning of the LDC’s pipes or distribution system) to the end user. In this case, customers purchase natural gas directly from the wellhead or from a marketer and arrange transportation. The gas then flows from the wellhead to the city gate. The LDC then distributes the gas from the city gate to the customer’s premises.

Indiana Sales

Table 1 below presents sales information for Indiana’s four largest LDCs: Citizens, IGC, NIPSCO, and SIGECO. Sales figures are based on sales of gas made by LDCs to customers that

⁵ A municipally owned utility may be removed from the jurisdiction of the commission for the approval of rates and charges and of the issuance of stocks, bonds, notes, or other evidence of indebtedness, if the municipal legislative body adopts an ordinance removing the utility from commission jurisdiction. (IC 8-1.5-3-9.1). A municipally owned gas utility that opts out under this provision is still subject to Pipeline Safety Division requirements.

purchase bundled service. These four companies collectively represent about 90 percent of the natural gas retail deliveries in the state. For more detailed information, see Appendix A.⁶

Table 1

Total Sales (Dth) by Class for the Four Largest Gas Utilities in Indiana - 2005⁷					
Utility	Residential	Commercial	Industrial	Other	Total
Citizens Gas	22,491,466	12,420,430	1,681,995	-----	36,593,891
IGC	44,623,000	19,488,000	899,000	-----	65,010,000
NIPSCO	58,385,412	20,500,081	13,878,798	112,349	92,876,640
SIGECO	7,274,568	3,643,427	393,199	4,566	11,315,760
Total	132,774,446	56,051,938	16,852,992	116,915	205,796,291

Customers

It is important to understand that while the customer segments described below are those served by the LDCs regulated by the IURC and are of primary concern to both the LDCs and the Commission, other customer segments have a significant impact on demand in the total market, and therefore at least indirectly impact those identified as customers of the LDCs with which the Commission works.

Residential

The residential customer class typically consists of single family homes and small multifamily dwellings, characterized by smaller sales volumes per customer than the commercial and industrial classes. Typically the LDCs are the merchants for the residential customer class, meaning the LDC buys the gas from producers, arranges for its transportation, and resells the gas to customers. NIPSCO is the only LDC that allows their residential customers an option of using the LDC as a transporter and to select an alternative natural gas supplier. The “NIPSCO Choice” program (also discussed under “Competitive Initiatives in Natural Gas”), which offers retail and

⁶ Retail sales are typically categorized by class of customer, i.e., residential, commercial and industrial customers. The designation “other” refers to sales to public authorities, i.e., governmental entities.

⁷ IURC Annual Reports filed by utility with the IURC.

small business customers non-traditional alternatives including a choice option of purchasing natural gas through a third party marketer and looking to NIPSCO for transportation (see the “Competitive Initiatives in Natural Gas,” section).

Commercial

Typical commercial customers include office facilities, retail and wholesale facilities, midsize residential complexes (primarily apartments) and institutional users. They account for mid-range consumption volumes and may be served through either a bundled or transportation relationship.

Industrial

Members of the industrial class typically purchase much higher volumes of gas than residential or commercial customers. The LDC may provide bundled service, as with the residential class (and to a lesser extent, commercial); or the industrial customer may buy gas directly from the producer or a marketer, paying the LDC solely for the distribution costs associated with delivering the gas from the city gate to the industry’s facility. Approximately 90% of natural gas sales in Indiana to industrial users are transacted through marketers and/or from direct purchases from producers.

According to “The Natural Gas Industry and Markets in 2004,” published by the Energy Information Administration’s (EIA) Office of Oil and Gas in February 2006, Indiana ranked 6th in the nation among the states in industrial gas consumption in 2004 (the latest year for which detailed information is available), and ranked 3rd in the nation in terms of *increased* industrial consumption in 2004 over 2003.⁸

While sales of natural gas by the four largest LDCs to industrial users as reported in Table 1 account for less than 10% of their sales, industrial consumption of natural gas in Indiana

⁸ “The Natural Gas Industry and Markets in 2004,” Office of Oil and Gas, The Energy Information Administration, February 2006, p. 3

in 2004 accounted for just over half of total usage of natural gas in Indiana.⁹ In 2004, natural gas consumed for generation of electric power increased by 6.4% nationally compared with 2003. Much of that use is by “merchant plants” and other “peaker” plants which are primarily used to meet seasonal peak demand for electricity during the summer cooling months.,

Since regulated gas-powered generation facilities are allowed by Indiana and many other states to pass along fuel costs directly to their customers, and since unregulated gas-powered generation facilities are able to set rates based on market demand for electricity, such facilities have little or no incentive to contain fuel (natural gas) costs, thus simply paying what the market will bear. When supply and demand are in such close balance, as they have been in the natural gas market for some years now, the impact is an upward price pressure for users. To the extent that higher natural gas prices have a negative impact on Indiana companies’ ability to compete, the greater the potential impact on economic development and public policy.

Natural Gas Market

General Supply and Demand Factors

The United States has large potential resources of natural gas. The Natural Gas Supply Association estimates that there is 1,279.5 trillion cubic feet (Tcf) of recoverable natural gas in the U.S.¹⁰; although the American Gas Association (AGA) approximates over 215 Tcf of that amount is federally restricted. The U.S. has relatively flat production growth corresponding with an overall relatively predictable demand growth rate. The EIA projects 1.3% growth in 2006 and .4% in 2007.¹¹ Currently approximately 85 percent of the natural gas used in the United States is of domestic production.¹²

The supply and demand of natural gas plays a major role in determining price. For the past several years, the supply and demand for natural gas have been in relatively tight

⁹ Natural Gas Annual 2004, Energy Information Administration, p. 81

¹⁰ NaturalGas.org (<http://www.naturalgas.org/business/analysis.asp>)

¹¹ Energy Information Administration’s Short-Term Energy Outlook August 8, 2006 release.

¹² The Natural Gas Supply Association (http://www.ngsa.org/facts_studies/gasfacts.asp)

equilibrium. Thus, relatively modest disruptions in supply have an impact on both current and future prices of natural gas which is out of proportion to the true size of the disruption. Even the sheer perception of disruption or imbalance in the market causes immediate fluctuations or price volatility.

Short-term

Short term changes are reflected by immediate fluctuations in price. On the supply side, weather and unpredictable events may damage wells and pipelines. In August and September of 2005, Hurricanes Katrina and Rita crossed right through the heart of the Gulf producing region. In their wake, many rigs and wells were shut down or virtually destroyed resulting in immediate decreased production of 561 billion cubic feet (Bcf) for 2005 or 15 percent of production.¹³ Some of the Gulf production facilities remain off-line even today.

Disruptions do not necessarily have to occur to the domestic natural gas infrastructure to have an impact on natural gas prices. The price of natural gas also tends to move loosely in tandem with the price of crude oil; therefore the prospect of crude oil shortages also affects the price of natural gas domestically. Some large volume customers (primarily industrial and electricity generation consumers) have the ability to switch between natural gas and other fuels. High oil prices may cause increased demand on the supply of natural gas. Other issues dealing with supply include the availability of skilled workers for drilling activities, availability of equipment, permitting, and well development.

The most significant impact on natural gas prices in the short-term is weather. Everyone knows that when the temperature goes down in the winter, consumption and price for natural gas tend to increase. If the winter season is colder-than-normal, there is a large demand on gas for heating thus putting a strain on supply and driving up price. If the summer is hotter-than-normal, there is a need for home cooling which adds to the demand of natural gas in electric generation.

¹³ Minerals Management Service's Hurricane Katrina/Rita Evacuation and Production Shut-in Statistics Report as of December 29, 2005.

The reverse scenario can have the opposite effect. Warm winters reduce the need to draw supplies from storage and cool summers allow more gas to be put into storage. Ample storage helps with price stability as described in the “Role of Storage Gas” section.

Long-term

Taking into consideration the short term supply and demand issues with natural gas, you must consider the long term issues as well. Long term supply is closely linked with economic development. The more the country grows, expands, and develops, the greater the need for gas. To ensure there is adequate supply for the growing country, production needs to increase. That means getting most gas wells in the gulf region back to normal production levels (most of the wells are back online after hurricanes Katrina and Rita). Some wells will not be returned to service because the costs to return the wells to service outweigh the benefits due to a limited amount of remaining supplies.

A majority of imported gas comes from Canada and increasing this amount would help long term supply concerns, but due to Canada’s economic and demand growth, imports to the U.S. have been stagnant. Liquefied Natural Gas (LNG) from overseas is another option for natural gas supplies. Currently the United States imports about one percent of its natural gas supply using this method.¹⁴

LNG has concerns that need to be considered before a strong reliance on this source is generated. Security issues are a major concern due to increased shipping traffic into ports and the need for regasification¹⁵ facilities. LNG pricing is also a concern. The demand for LNG is worldwide so the international competition drives the price, leading to reliability concerns. Ships in route for the U.S. will change course if a higher price opportunity arises in another country.

Figuring out long term supply issues also leads to long term demand situations. The growth of natural gas use for electric generation increases demand. The heat wave of July 2006

¹⁴ Natural Gas Supply Association (http://www.ngsa.org/facts_studies/gas_supply.asp)

¹⁵Regasification is the process in which liquefied natural gas is converted back to a gaseous state.

led to supplies being withdrawn from storage. Continued environmental and cost concerns lead to more electric generation plants being built with the ability to use alternative sources of fuel. If current trends continue, the demand for natural gas will continue to grow.

Role of Storage Gas

Natural gas storage plays a vital role in price stability and maintaining the reliability of supply needed to meet the demands of consumers. Utilities use storage in their portfolios as a means of managing price spikes and unpredictable events (i.e. weather). Storage is also used to ensure adequate supplies of natural gas are in place for these seasonal demand shifts and unexplained demand surges. Although as overall demand grows, the number of storage facilities needs to increase in order to sustain the mitigation effect.

Natural gas is generally injected into storage during the non-heating season when demand and prices are typically lower. This usually runs from April through October. During the heating season, withdrawal occurs when demand and price are typically higher, which is usually from November through March.¹⁶

Historical Rates for Natural Gas

The price of natural gas has proven to be volatile. Approximately 70% of a customer's bill consists of the cost of the natural gas commodity itself (this percentage varies as the cost of gas fluctuates). When the price of gas fluctuates, gas bills fluctuate as well. Table 2 is an illustration of what Commission-regulated LDC's have charged customers over the last five years.

¹⁶ NaturalGas.org (<http://www.naturalgas.org/naturalgas/storage.asp>)

Table 2

RESIDENTIAL GAS BILL COMPARISON (2002-2006)							
BILLS CALCULATED BASED ON RATES IN EFFECT JANUARY FIRST OF EACH YEAR							
RANKED HIGHEST TO LOWEST BASED ON 5 YEAR AVERAGE							
IURC GAS DIVISION							
		Consumption Level of 200 Therms					
Rank	Utility Name	5 Year Average	2006 Bills	2005 Bills	2004 Bills	2003 Bills	2002 Bills
1	Lawrenceburg Gas Co. (Rate G-1)	231.73	343.38	248.34	213.09	156.64	197.22
2	Aurora Municipal Gas Utility	223.50	338.94	240.59	205.25	147.77	184.96
3	Lawrenceburg Gas Co. (Rate G-2)	223.22	365.58	221.12	211.84	138.18	179.40
4	Boonville Natural Gas Corp.	220.74	310.11	219.08	196.18	172.63	205.70
5	South Eastern Indiana Gas Co.	218.10	309.35	250.45	211.19	147.09	172.41
6	Indiana Utilities Corp.	215.67	290.98	238.26	209.20	150.89	189.05
7	Switzerland County Natural Gas Co.	214.56	382.34	173.19	173.19	144.31	199.79
8	Ohio Valley Gas Corp. (ANR) (2)	212.53	264.24	227.40	225.70	164.94	180.37
9	Ohio Valley Gas Corp. (TXG)	211.07	286.74	235.80	220.18	144.48	168.15
10	Indiana Natural Gas Corp.	208.84	301.16	204.41	208.96	151.36	178.29
11	Community Gas Corp. (Rate 1) (1)	208.69	286.17	206.08	199.96	145.77	205.47
12	Westfield Gas Corp.	208.40	262.97	193.87	204.97	167.15	213.05
13	Ohio Valley Gas Inc.	205.71	276.84	217.56	223.52	137.72	172.89
14	Peoples Gas and Power Co. (4)	201.98	303.94	206.02	216.02	121.94	162.00
15	Community Gas Corp. (Rate 2) (1)	197.87	286.17	206.08	199.96	123.33	173.82
16	Northern Indiana Public Service Co.	196.65	295.08	199.70	181.31	179.35	127.81
17	Chandler Natural Gas Corp.	196.53	292.09	191.54	171.08	148.57	179.36
18	Midwest Gas Corp. (1)	194.82	293.04	195.12	205.12	125.25	155.57
19	Indiana Gas Co.	194.64	289.58	209.70	179.40	161.32	133.22
20	Fountaintown Gas Co.	194.47	267.61	239.98	139.58	144.86	180.32
21	Northern Indiana Fuel and Light Co.	182.70	220.71	187.95	170.11	141.90	192.85
22	Citizens Gas and Coke Utility	174.78	242.99	190.49	167.85	146.66	125.92
23	Southern Ind. Gas & Electric Co.	174.14	290.30	171.72	154.84	146.42	108.80
24	Kokomo Gas and Fuel Co.	172.41	227.66	182.98	165.80	131.60	154.01
25	Snow and Ogden Gas Co.	109.78	148.10	100.20	100.20	100.20	100.20

This Gas Bill Analysis should be construed as an informative guideline. It is a snapshot in time. Gas rates change frequently, in some cases monthly, due to gas cost adjustments. Using this analysis to draw conclusions about a particular utility's performance would be difficult due to many factors such as utility size and resources, time since the last rate case, storage options, geographic location, base rates, customer density, and gas cost adjustment in effect at the time of bill calculation.

2005-2006 Winter Market Conditions

Natural gas supplies meet one-fourth of the United States' energy needs. As a result of the deregulation and commodization of natural gas at the wellhead, market conditions now impact natural gas prices almost immediately. This past winter again proved this economic reality.

Market indicators for the 2005–2006 heating season prior to the landfall of Hurricanes Katrina and Rita suggested that gas bills were going to be higher than for the 2004-2005 heating season because of increasing demand and prices. Anticipating this scenario, all of the major gas utilities conducted customer education campaigns to warn their customers that gas bills would likely increase, perhaps significantly, over the prior year.

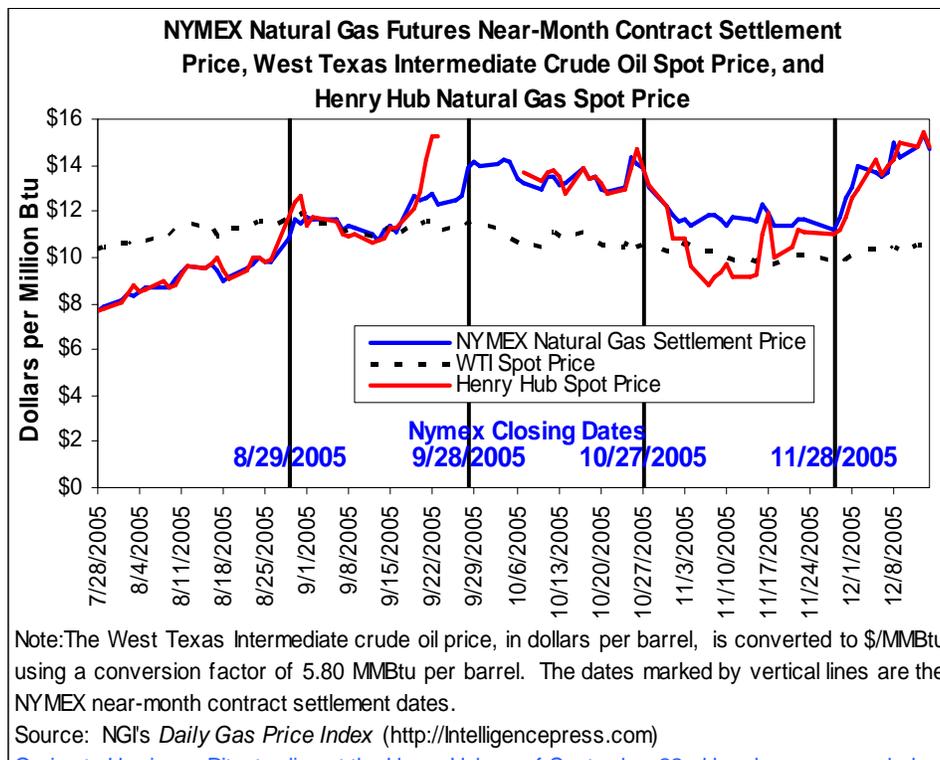
Natural gas prices decreased significantly after experiencing dramatic increases in the fall of 2005. Natural gas in storage across the country (usually an indicating factor for prices) was at a five-year high at the start of the heating season, and stayed within or above the five-year historical range for the remainder of the winter (see Chart 2).

Hurricane activity in the Gulf was at an historic high in the late summer and fall of 2005. Two different hurricanes of those which made landfall, Katrina and Rita, greatly impacted the natural gas industry. These hurricanes resulted in over 800 Bcf of cumulative shut-in natural gas production on the Gulf Coast.¹⁷ The loss delayed and will continue to delay recovery of natural gas production in the area. Even if platforms and pipelines were unaffected or readily restored to service, the gas which was produced often could not flow to market without treatment. In 2003 (the latest year with complete data), almost three-fourths of total U.S. marketed gas production was processed prior to delivery to market. A number of processing plants in Louisiana and Texas, with capacities equal to or greater than 100 MMcf/d, were knocked out of service by the hurricanes.

¹⁷ Minerals Management Service's Hurricane Katrina/Rita Evacuation and Production Shut-in Statistics Final Report, June 19, 2006.

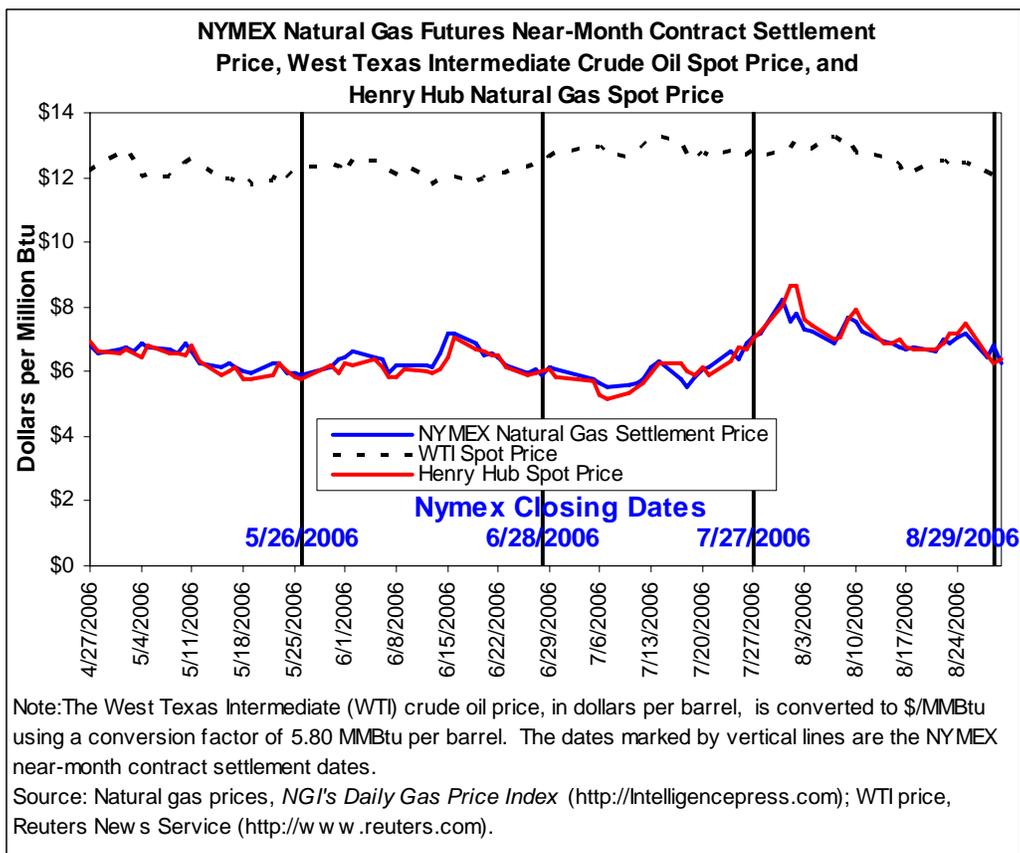
Another factor that increased the price for natural gas was the threat of a reduction in the oil supply because of the continued U.S. involvement in Iraq. All of these variables converged to put upward pressure on gas prices, causing the high price of gas to increase even higher from \$8.15 per Mcf¹⁸ in August 2005 to over \$14.38 per Mcf by October 2005. Prices tended to relax throughout the winter. Chart 1a shows the impact of Hurricanes Katrina and Rita on NYMEX natural gas futures and Chart 1b indicates more recent futures activity.

Chart 1a



¹⁸ For purposes of this Report, 1 Dekatherm (Dth) = 1 thousand cubic feet (Mcf) = 1 MMBtu.

Chart 1b



Market Projections

A competitive market through supply and demand principles determines gas prices. Unfortunately for gas consumers, gas prices can be expected to continue to reflect price volatility over the next few years as gas prices respond to economic incentives and demand, while supply increases will come on more gradually. The balance between supply and demand is tight, leading to large potential price swings for any events that affect the industry.

Gas prices during the decade of the 1990s were stable, fluctuating around \$2.00 per Mcf. The price spike of the 2000–2001 heating season was a dramatic run-up in gas prices with prices briefly increasing from their historical low of \$2.00 to almost \$10.00 per Mcf. This increase in wholesale prices quickly resulted in a significant increase in gas production which expanded the supply of natural gas for the 2001–2002 winter. The resulting increased inventory of natural gas

combined with reduced industrial demand because of the prior season's high prices and warmer-than-normal weather, resulting in reduced demand by all customers. Natural gas prices responded to the oversupply situation by falling. This in turn reduced not only the price but also the quantity of gas available for the 2002–2003 winter, as gas rigs shut down in response to falling prices. As noted in the previous section, the storage of gas across the country was at a five-year high at the beginning of the 2005-2006 heating season and remained well within the five-year historical range for the rest of the winter.

Future Demand

Gas demand is projected to increase at an average annual rate of approximately one percent between 2004 and 2030. Past growth projections were higher primarily because of the rapid growth in the electric generation sector, but high gas prices have discouraged the construction of further new natural-gas-fired electricity generation plants, which will ease demand pressure somewhat, going forward.¹⁹

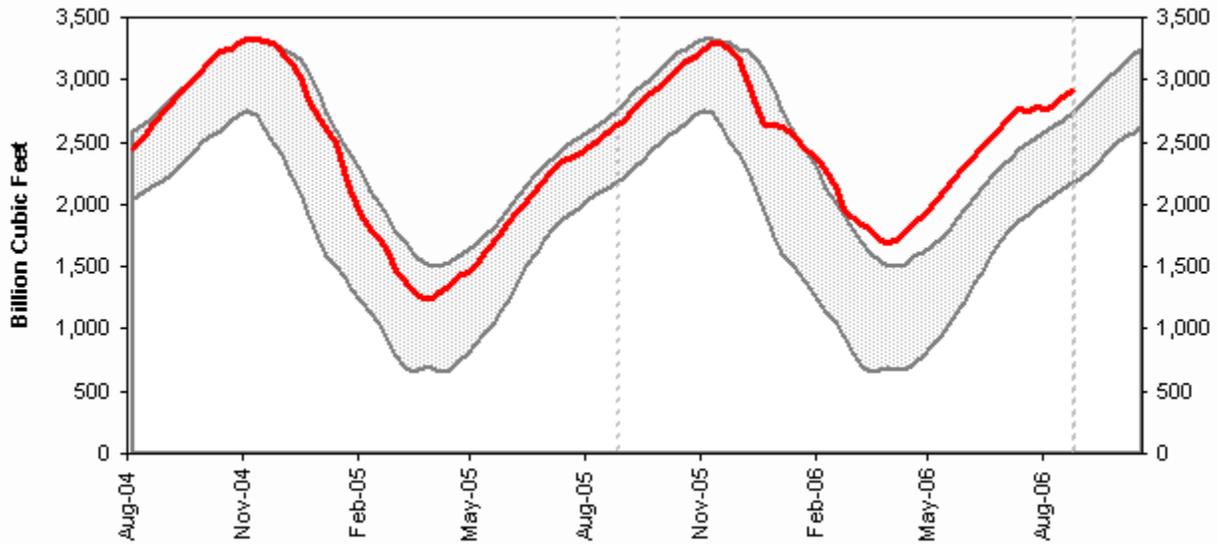
Future Supply

Today the market is still nervous about gas prices and supply. This concern is likely to continue over the near-term. The gas industry has recently been operating at the tight end of effective capacity. As production nears capacity, the price responses to changes in demand or supply intensify. For example, if production is at its peak and demand increases, prices will increase far more than if idle capacity existed. Natural gas in storage is currently at a five-year high. As of August 25, 2006 total working gas is about 12.4% greater than the 5 year average.

¹⁹ Energy Information Administration's Annual Energy Outlook 2006.

Chart 2

Working Gas in Underground Storage Compared with 5-Year Range



Notes: The red (dark, solid) line represents the actual amount of natural gas in storage. The shaded area represents the five-year average.

Source: Form EIA-912, "Weekly Underground Natural Gas Storage Report", August 31, 2006. The dashed vertical lines indicate current and year-ago weekly periods.

Table 3

All Volumes in Bcf	Current Stocks 8/25/06	One-Week Prior Stocks 8/18/06	Implied Net Change from Last Week	Estimated Prior 5-Year (2001-2005) Average	Percent Difference from 5 Year Average
East Region	1,673	1,639	34	1,486	12.6%
West Region	398	391	7	353	12.7%
Producing Region	834	827	7	746	11.8%
Total Lower 48	2,905	2,857	48	2,585	12.4%

Source: Energy Information Administration: Form EIA-912, "Weekly Underground Natural Gas Storage Report," and the Historical Weekly Storage Estimates Database.

Row and column sums may not equal due to independent rounding.

Future Price

With the tight supply situation, gas price volatility, and increasing demand, high gas prices relative to historic levels are expected to persist. The adequate amount of storage should ease some pressure, but storage can be quickly depleted if a colder-than-normal winter is followed by a warmer-than-normal summer or vice versa. As mentioned in a previous section, the summer of 2006 saw withdrawal from storage for the first time ever. There are unpredictable factors that affect the price of gas, therefore it is difficult to accurately predict what gas prices will be in the future.

General Factors That Could Decrease the Price of Gas

Natural gas exploration is one intermediate term solution to lowering the cost of gas. While there is an abundant supply of deep-sea natural gas on the Outer Continental Shelf (OCS) that can be retrieved in a safe and environmentally sound manner, 85% of these supplies are federally restricted to exploration.²⁰ High prices have encouraged drilling for new supplies. U.S. total rigs drilling reached a record high of 1,683 for the week ending July 21, 2006.²¹ Nevertheless, even with this intensified drilling activity, the EIA expects U.S. gas production to be slightly lower this year with much of the reduction caused by the effects of Hurricanes Rita and Katrina.²²

Technological progress affects natural gas production by reducing production costs and expanding the economically recoverable gas resource base. An example is the relatively recent development of technologies for producing unconventional natural gas resources, which allow previously uneconomical deposits to be produced profitably, whereas 50 years ago industry technology was capable of exploiting only conventional deposits.

²⁰ Consumer Alliance for Energy Security Report on Natural Gas Exploration-The Solution Exists Today

²¹ EIA's Natural Gas Weekly Updated, July 27, 2006.

²²Energy Information Administration's Annual Energy Outlook 2006.

Experts from the AGA are confident that the United States is not "running out" of natural gas. There are areas of the country, both onshore and offshore, with excellent prospects for new natural gas discoveries. Gas producers are finding extensive new gas reserves in the Rocky Mountain region and in the San Juan Basin of New Mexico, where innovative technology permits gas production from underground coal beds.

Government legislation is a second option to lowering prices. It is unknown if these measures will bring down energy prices. The proposed Deep Ocean Energy Resources Act of 2006 (DOER Act, H.R. 4761), would expand domestic offshore oil and natural gas production and could possibly create more affordable and stable energy supplies. Natural gas exploration would provide greater access to this supply and could help reverse the current tightness in supply and demand of natural gas. A balance is needed between U.S. energy policies that promote the use of natural gas, driving up demand, and restrictions to access of domestic supplies.

Most of the projected growth in U.S. natural gas imports is in the form of liquefied natural gas. Cooling natural gas to about -260°F at normal pressure results in the condensation of the gas into liquid form, known as LNG. LNG is a very efficient form of natural gas, since LNG takes up about one six hundredth the volume of the gaseous state, making it more economical to transport

While LNG is reasonably costly to process, advances in technology are reducing the costs associated with the liquefaction and regasification of LNG. Because it is efficient to transport, LNG can make development of stranded natural gas deposits, for which the construction of pipelines is uneconomical, more attractive. Although it currently accounts for only about one percent of natural gas used in the United States, it is expected that LNG imports will increase. According to the EIA, the U.S. imported 0.17 Tcf of natural gas in the form of LNG in 2002. LNG imports are expected to increase at an average annual rate of 15.8 percent, to levels of 4.80

Tcf of natural gas by 2025.²³ LNG imports represent an increasingly important part of the natural gas supply picture in the United States. LNG which is imported by the United States comes via ocean tanker. The U.S. gets a majority of its LNG from Trinidad and Tobago, Qatar, and Algeria, and also receives shipments from Nigeria, Oman, Australia, Indonesia, and the United Arab Emirates.²⁴ Concerns about LNG's reliability due to international competition were discussed in a previous section. Although LNG is expected to play a major role in future supply needs, other options such as long-term contracts, increased efficiency, and alternative sources of fuel such as coal gasification are also possibilities to ease supply needs.

Competitive Initiatives in Natural Gas

National Overview

With the implementation of the Natural Gas Policy Act of 1978, Congress began a process that ended federal control over the price of gas at the wellhead. This process also set in motion a series of public policy changes by FERC and state regulators which has culminated in "customer choice" programs in the natural gas industry.

Natural gas choice allows customers to choose a supplier other than the LDC. The local utility continues to own and maintain the pipes which deliver the gas service to consumers' homes or businesses, but consumers can choose the company which provides their natural gas. In today's competitive market, suppliers offer a variety of prices, incentives, or services to attract business. Customers have the opportunity to comparison shop for the best deal, just as they do when they buy a car, home, or their weekly groceries. Since 1995, several states have enacted legislation or rules which allow residential customers and small commercial customers to purchase gas from someone other than the local gas company.

As of December 2005, choice programs are operating in twenty-one states and the District of Columbia. About 3.9 million residential customers participate in choice programs

²³ Natural Gas Supply Association Report on LNG

²⁴ Natural Gas Supply Association Report on LNG

nationwide. Participation rates vary dramatically across programs, ranging from those that attract no customers to participation rates of eighty-two percent. Some states have expanded their programs to include more eligible customers while other programs have faltered or simply reached a plateau.²⁵

Nationally, there has been a decline in enrollment in each of the past two years due to concerns about high and variable natural gas prices and reluctance to deal with gas marketers. Gas marketers operate a low profit-margin business, where marketers are selling a commodity to a mass market. Marketers must purchase gas and transportation in the same markets as LDCs. Some marketers have discovered customer service and marketing costs cut too deep into their profits.²⁶

Choice programs continue to evolve over time as circumstances change. These programs still provide a challenge to LDCs, marketers, and regulators as they change in size and scope, in response to market realities over which no one has control. The learning process and reconfiguring of choice programs can be expected to continue.

Status of Customer Choice in Indiana

The Commission approved NIPSCO's "Choice" program in its Order of October 8, 1997, in Cause No. 40342. The utility began phasing in its customer choice program in April 1998. Eligibility was increased from 50,000 residential and 1,500 business customers in the first year to include the entire customer base of 647,000 and 56,000, respectively. The Choice program's enrollment caps are 150,000 residential customers and 20,000 commercial customers.

NIPSCO's pilot Choice program was scheduled to end on March 31, 2005, but was extended through April 30, 2010, under an agreement between NIPSCO and the Indiana Office of Utility Consumer Counselor (OUCC), approved by the Commission in January 2006. The

²⁵ EIA's Retail Unbundling – U.S. Summary

²⁶ The National Regulatory Research Institute, *Survey on the Features and Regulatory Oversight of Gas Choice Programs*, NRRI 03-02, February 2003, pp. 1-2.

agreement includes a reduction in the interstate transportation costs charged to residential and small business customers. Under the agreement, marketers are now required to be registered with the Commission.

NIPSCO’s alternative regulatory plan includes the choice program as well as a price protection service (PPS) in which customers have a choice of a fixed or a capped rate (which includes a price premium) set in advance by the company for a year. Customers who cancel a PPS agreement before the year is up are subject to a cancellation penalty. The company also offers a “DependaBill” payment plan in which monthly prices are fixed without an end-of-year “true up” adjustment, but which also includes a monthly fee of up to 10 percent. Early termination penalties also apply. Neither the PPS nor the DependaBill rates are regulated by the Commission. NIPSCO is the only Indiana LDC that offers choice for its residential customers.

Table 4

STATUS OF NIPSCO CHOICE PROGRAM

As of July 31, 2006

As of 12/31/03	Residential	Commercial
Total Customers	602,000	50,000
Choice Customers	43,875	6,002
Percentage of Total Customers	7.3%	12.0%
As of 5/31/05		
Total Customers	647,439	56,630
Choice Customers	50,051	8,729
Percentage of Total Customers	7.7%	15.4%
As of 7/31/06		
Total Customers	647,309	55,749
Choice Customers	48,368	12,097
Percentage of Total Customers	7.5%	21.7%

Commission Actions Addressing Price Volatility and Supply Reliability

Gas Cost Adjustments

Additional Monitoring

As part of its normal course of business, the Commission continues to monitor gas prices and purchasing practices in the Gas Cost Adjustment (GCA) proceedings²⁷ for gas utilities under its jurisdiction. The scrutiny within these proceedings by both the Commission and the OUCC has increased dramatically since 2000, due to volatility in natural gas prices. The Commission, through its orders, has encouraged utilities to explore innovative ways to control gas prices using strategies such as physical and financial hedging, fixed and ratable purchases, efficient use of storage, and other portfolio management techniques.

In response to the Commission's interest in the issue of gas price volatility, many utilities have begun to include testimony on their price and volatility mitigation efforts as part of their normal filings in GCA proceedings. Currently, information provided by LDCs includes gas procurement strategies, gas purchasing targets by type of contract, storage options, and price projections. This information has been beneficial to Commission staff in the analysis of each GCA case. The Commission has supported and encouraged diversified portfolios for utilities. These portfolios generally have consisted of physical hedge purchases, secured volumes of storage gas, and to a lesser extent, financial hedges which help to mitigate gas price volatility.

NIPSCO's Gas Cost Adjustment

In its Order of August 18, 1999 in Cause No. 41338, the Commission approved a proposed redesigned mechanism for NIPSCO's GCA consisting of two parts: a monthly commodity filing and an annual demand charge filing. Under this mechanism, NIPSCO makes a

²⁷ A gas cost adjustment (GCA) is an adjustment to effective rates which reflects the fluctuating cost of purchased gas. LDCs are allowed to pass-through the cost of gas and may not profit from this pass-through. The GCA statute may be found at I.C. 8-1-2-42.

monthly commodity filing which will determine the gas commodity component of the GCA factor for a calendar month. NIPSCO began making these monthly commodity filings on September 1, 1999. The Company makes its annual filing three working days prior to September 1 of each year, to determine the demand component of its gas costs for the twelve months beginning November 1 of each year. On August 29, 2005, NIPSCO filed its seventh annual filing: Cause No. 41338 GCA 7.

The Commission held Public Evidentiary Hearings on December 13 and 15, 2005 and January 19, 2006. A Field Hearing was also held on February 22, 2006. An Interim Order approving the annual demand charge on a temporary basis was issued on November 22, 2005 and a Final Order was approved on July 26, 2006. On August 29, 2006, NIPSCO filed its eighth annual filing in Cause No. 41338 GCA 8. That case is currently pending.

Positive changes that resulted from previous Commission Orders are: 1) improved communication and information exchange between NIPSCO, the OUCC's auditors, and Commission staff, 2) ongoing meetings between the Parties and Commission staff, which have resulted in significant improvements to monthly and annual GCA filings, and 3) increased volatility mitigation, which has been reflected in customers' bills.

GCA Timeframes – semi-annually, quarterly, and monthly

Most of Indiana's LDCs continue to file traditional quarterly GCA petitions. Two LDCs, NIPSCO and Valley Rural Utility Company, use a monthly GCA factor with an annual hearing to discuss important issues pertaining to the previous and upcoming years, to true-up any under or overestimated costs, and to present known demand costs for the upcoming year. NIPSCO's and Valley Rural's GCA mechanisms, approved under the Alternative Utility Regulation statute²⁸, allow monthly flexing up or down based on prevailing market conditions.²⁹

²⁸ Indiana Code § 8-1-2.5 Alternative Utility Regulation

²⁹ Cause No. 41338 ARP, NIPSCO; Approved 12/1/1998 and Cause No. 42115 Certificate of Need and ARP, Valley Rural Utility Company; Approved 5/8/2002

In addition to the annual hearing requirements, both LDCs are required to make monthly submissions with the Commission showing commodity prices and GCA factors to be implemented for the upcoming month. NIPSCO, an investor-owned LDC, files quarterly earnings information. Valley Rural Utility Company, a not-for-profit, recovers its incremental gas costs over base rates on a monthly basis as approved in its Alternative Regulatory Plan (ARP). Recoverable costs are subject to a cap, are subject to review in an annual gas supply proceeding that addresses the components of gas supply for the upcoming year, and seeks final approval of the gas supply costs charged during the preceding twelve months. As of October 2005, Valley Rural was providing service to more than 280 customers.

Three of Indiana's major LDCs continue to file quarterly GCAs, but are allowed to adjust their approved GCAs monthly. IGC and SIGECO, both subsidiaries of Vectren Energy Delivery of Indiana, are allowed to “flex,” or adjust, their quarterly GCA factors down from Commission approved maximum factors (caps) once a month, in an effort to more closely reflect the most current gas prices. These flex-down mechanisms are approved on a cause-by-cause basis. Additionally, Citizens petitioned to file quarterly with monthly adjustments to its GCA factor on July 26, 2002.³⁰ Citizens may flex its monthly GCA factor up or down, with a \$1.00 per Dth maximum flex. The mechanism was initially approved for a test period of one year.

On April 29, 2003, representatives of Citizens, the OUCC, and the Commission staff met to review the performance of the GCA monthly flex mechanism. As a result of that meeting, the parties filed a report to the Commission on August 15, 2003, and an amended settlement agreement on the GCA flex issue on October 9, 2003. The Commission issued an order on March 17, 2004 which extended use of the flex mechanism through August 2005 (GCA 86). A subsequent settlement agreement was filed on August 23, 2005, extending the use of the flex mechanism through September 2008 (GCA 98). Thus with Citizens now on the monthly flex

³⁰ Cause No. 37399 GCA 75, Citizens Gas & Coke Utility, approved September 4, 2002.

mechanism, the majority of gas bills rendered in Indiana reflect GCA factors that change monthly.

Gas Cost Incentive Mechanisms

A Gas Cost Incentive Mechanism (GCIM) provides performance incentives to LDCs for gas supply acquisition performance compared to a market standard (benchmark). Benchmark prices reflect natural gas commodity prices for geographic locations representative of the supply source where the gas was purchased, and are typically calculated monthly. The benchmark price is then divided by the actual amount of gas purchased to determine the benchmark dollars.

If an LDC's actual natural gas commodity purchases are above or below the benchmark, predetermined percentages of the positive or negative differentials are shared between the utility and its customers. For example, if the actual gas purchases are slightly below the benchmark dollars, a higher percentage of the savings goes to the customers; if the actual gas purchases are a greater percentage below the benchmark dollars, a higher percentage of the savings differential is shifted to the LDC. This mechanism also works in reverse. Customers absorb costs which are only slightly higher than the benchmark; however, if costs exceed the benchmark by a greater amount, a higher percentage of the differential is absorbed by the LDC.

NIPSCO has had a GCIM since 1997 which was approved as part of its ARP.³¹ Over the years since the NIPSCO GCIM has been modified and continued in effect. Further modifications to the NIPSCO GCIM were proposed in Cause No. 42884. A settlement agreement filed by the parties to that cause was subsequently approved on January 31, 2006. IGC, SIGECO, and Citizens implemented GCIMs as part of an ARP approved on July 24, 2002.³²

³¹ Cause No. 40342, Northern Indiana Public Service Company, approved on October 8, 1997.

³² Cause No. 42233 ARP which has been consolidated with Cause Nos. 37394 GCA 50-S1 and 37399 GCA 50-S1.

Other Gas Issues Affecting Indiana

Customer Deposit Rulemaking

On June 1, 2005, the Commission published a Notice of Intent to adopt a rulemaking concerning utility deposits, reconnections, and disconnections solely for gas utilities by amending existing regulations contained in 170 IAC 5-1-15 and 170 IAC 5-1-16. This was done as part of the Commission's continuing process of reviewing and reevaluating its rules, and was particularly relevant for the gas utilities and their customers given the volatility in the price of natural gas. Following the normal rulemaking process, which includes public input in the form of written comments and a hearing, the Commission on November 30, 2005 approved a new natural gas rule which reduces the maximum deposit amount that gas utilities may charge customers.

The new rule is designed to make deposits more affordable, while at the same time minimizing the cost of bad debt which must be absorbed by ratepayers. It reduces the deposit amount for as many as 95% of natural gas utility customers in Indiana from the previous maximum of four months to two months of estimated annual usage. The rule sets a maximum deposit of $\frac{1}{6}$ (two months) the estimated annual usage for:

- New customers who meet credit standards,
- Customers who implement budget billing at any time of the year, or
- Low income customers who receive LIHEAP heating assistance during the heating season from November 1st to March 15th.

The maximum allowable deposit for high risk customers is $\frac{1}{3}$ (four months) the estimated annual usage. While the rule did not become officially effective until March 15, 2006, most gas utilities voluntarily put the rule into effect for the entire 2005/2006 winter heating season.

Low-income Assistance Programs

Citizens, Indiana Gas, SIGECO Universal Service Plan

On August 18, 2004, the Commission approved a settlement agreement between the OUCC, Citizens Action Coalition of Indiana (CAC), an ad hoc group of customers known as the Manufacturing and Health Providing Customers (MHPC), Citizens Gas, and Vectren (IGC and SIGECO, collectively) in Cause No. 42590 for approval of a pilot “Universal Service Program.”

The Universal Service Plan is intended to assist eligible and qualifying low-income customers by providing them with a significant reduction in their gas bills. These bill reductions are based on tiers which take into account the additional burdens placed on those customers whose income level falls well below the poverty guidelines.

The pilot is set to expire December 31, 2006. Citizens and Vectren have filed for an extension of the program to May 31, 2008 with modifications. This case is currently pending under Cause No. 43078, and has been consolidated with Cause No. 43077 (see below).

NIPSCO’s Winter Warmth Program

On December 15, 2004, the Commission approved a one-year pilot for NIPSCO’s Winter Warmth Program in Cause No. 42722. The program was set to expire December 16, 2005, but was extended with certain modifications through December 31, 2006 in Cause No. 42927. The Winter Warmth Program is intended to assist qualifying customers by providing a combination of a reduced security deposit, security deposit assistance, and gas bill assistance prior to and during the critical winter heating season.

The pilot is set to expire December 31, 2006. NIPSCO has filed for an extension of the program to May 31, 2008 with modifications. This case is currently pending under Cause No. 43077, and has been consolidated with Cause No. 43078 (see above).

Citizens Gas & Coke Utility – Cause No. 42767

On December 29, 2004, Citizens Gas & Coke Utility filed a petition for the approval to increase its current rates and charges, changes to the terms and conditions of service, and an ARP. Citizens requested an increase in rates and charges to produce additional revenues of approximately \$39 million. The changes to terms and conditions of service were driven by Citizens' cost of service study which proposed the restructuring and modification of its customer classes by eliminating the Interruptible Service Class and merging those customers into the Large Volume Class.

Also included in this case, is the request for an ARP consisting of tracking mechanisms for bad debt expense (un-recovered revenue adjustment – “URA”) and a volume variance and conservation adjustment (VVCA). The proposed URA mechanism would calculate the level of revenues from unpaid customers bills as a base level to be included in base rates. Citizens may or may not recover those revenues; therefore, the URA would track the under or over collection amount in an annual tracking factor to be adjusted based on the amount recovered. The VVCA mechanism, which is a form of “decoupling”(discussed later in this report), would provide recovery of either under-collected revenues in warmer-than-normal weather or a refund for over-collected revenues in colder-than-normal weather. This case is currently pending an order from the Commission.

School Transportation Rates

The dramatic increase in gas prices prior to the 2005-2006 winter put a strain on many school districts in Indiana. These schools have budgets which do not allow much flexibility in spending, so when dramatic price increases occur, schools are forced to pull money from other resources. Although this situation is a major concern for schools, there has been a strong push in Indiana for schools to allocate more money towards teaching expenditures rather than non-instructional expenditures like energy costs. In order to allow more flexibility in school spending,

House Bill 1006 was enacted during the 2006 General Assembly. This law created greater flexibility for school spending, empowering schools to pool their purchasing power for natural gas. Currently, the two Indiana LDCs owned by Vectren, IGC and SIGECO, are the only LDCs which have applied for changes to their tariff of rates and charges in order to implement this law. Vectren's proposal was done through the Commission's 30 Day Filing Process and approved on August 9, 2006. The change also allows schools, no matter their size, to choose a natural gas marketer. Since the other LDCs have yet to request tariff changes, the need for these changes is unknown.

Decoupling

Natural gas utilities have experienced difficulty earning financial expectations due to declining usage per customer³³, warmer-than-normal weather, and rising fixed costs³⁴. In addition, many environmental, governmental, and consumer groups are advocating conservation of energy. Gas utilities are being encouraged to engage in energy conservation initiatives which are not in their financial interest under traditional ratemaking. Traditionally, the more gas sold, the more profitable it is to the utility.

Gas utilities and state regulators across the country have been working to remedy this situation by separating or "decoupling" the utility's recovery of fixed costs from the volume of natural gas sold. These decoupling mechanisms are usually periodic tracking adjustments which are trued-up by adjusting rates either up or down so that a utility recovers its authorized fixed costs regardless of usage, and can encourage energy conservation without suffering from adverse consequences.

The Commission has been reviewing recent proposals regarding decoupling mechanisms. One such proposal is that in the Citizens rate case currently pending before the Commission. As discussed previously, the VVCA is one such decoupling mechanism proposed. Also pending

³³ Although total sales have typically decreased, revenues have typically increased (see Appendix B). This is due to the rising cost of natural gas.

³⁴ Fixed costs are those costs incurred by the utility regardless of the volume of gas sold.

before the Commission is a settled agreement between Vectren and the OUCC. This agreement proposes an energy efficiency program comprised of two components: an energy efficiency rider and a sales reconciliation component or a decoupling mechanism. The energy efficiency rider will allow for the recovery of fixed costs while allowing for the utility to devote efforts to educating and providing consumers with ways to reduce their consumption.

Rockies Express

In January, 2006, representatives from Kinder Morgan visited the Commission to present information on a proposed pipeline, jointly owned by Kinder Morgan, Sempra Pipelines & Storage, and ConocoPhillips, that would give producers in the Rocky Mountain region the ability to deliver natural gas to the Midwest and to eastern parts of the U.S. The segment which passes through Indiana is projected to be completed in January 2009. As an interstate pipeline, the Rockies Express will be unregulated by the Commission in all aspects.

Gas Forums

Fall 2005

On October 13, 2005, the Commission held its annual gas forum on winter preparedness. Presentations were made by representatives from Citizens, Vectren, and NIPSCO. Much of the content of the presentations revolved around the impact of Hurricanes Katrina and Rita on natural gas prices. Predictions were made that ratepayers could expect to see dramatic increases in gas bills above the previous winter, and the utilities explained steps they were taking to mitigate the impact on their customers. The utilities also discussed the need for continued natural gas exploration and development, the need for funding for assistance programs to help low-income households; and the importance of conservation.

Small LDC

On November 2, 2005, the Commission held a gas forum for small LDCs. This allowed the smaller gas utilities to discuss matters that affect the small LDC community. Presentations on

gas portfolio management were made by representatives of Proliance Energy and EnergyUSA. A discussion followed among stakeholders, addressing specific concerns with regulatory rules, policies, and practices, as well as any statutory barriers at the state or federal level that need to be addressed. The main goal of this forum was to develop a list of helpful “take-away” tools which could be incorporated into business planning, to help companies provide safe and reliable natural gas to customers at the lowest reasonable cost.

Length of Contracts

On July 20, 2006, the Commission held a forum to expand discussions to specifically address long term contracts for the purchase of natural gas. Presentations were made by the AGA, RMI (an energy risk management firm), BP Energy Company, and the Chair of NARUC’s Committee on Gas.

The subject matters discussed included, the history of natural gas supply contracts; identification and marketing of physical and financial natural gas products for LDCs, industrial, and generation clients; long term contracts from the perspective of a state regulator; and hedging against price or supply volatility.

Increased Public Awareness on Weatherization³⁵ Events

The Commission has been actively engaged in making the public aware of the importance of Weatherization in reducing energy costs. This has been accomplished through the Weatherization of homes, public forums, radio, television, and newspaper interviews, and conservation tips on the Commission’s Website. In recognition of its efforts, Indiana is the first state in the nation to be inducted into the Energy Efficiency Champion Hall of Fame by the Washington D.C. based Alliance to Save Energy.

On October 13, 2005, Governor Daniels joined with the Commission, OUCC, Indiana Energy Association, and all of the major gas companies in Indiana at a weatherization event at a

³⁵Weatherization is the process of reducing air infiltration into a home or other structure and/or replacing appliances with more efficient appliances in order to reduce energy costs.

home in Indianapolis. Also, the Commission, OUCC, Indiana Energy Association, and the major gas companies partnered with the Alliance to Save Energy for events on February 13, 2006 and April 7, 2006 at homes in Fort Wayne and Evansville, respectively. At each event the homeowner was given a Proclamation from Governor Daniels expressing his support of weatherization. Chairman David Lott Hardy and Commissioner David Hadley are also participants on the Governor's Winter Heating Task Force.

Heartland Gas Pipeline

On October 5, 2005 in Cause Nos. 42729 and 42730, the Commission approved the request of Heartland Gas Pipeline for a certificate of public convenience and necessity to construct and operate an intrastate natural gas pipeline. The Commission found that construction of the pipeline will result in the diversification of gas supply and transportation options for Heartland's wholesale customer, Citizens Gas. In addition, the Commission approved the service agreement with Citizens, which will give Citizens access to the Chicago Hub, benefiting ratepayers of Citizens. Citizens will run the daily operations of the pipeline.

Role of the Commission's Pipeline Safety Division

The Pipeline Safety Division of the Commission has the responsibility of enforcing state and federal safety regulations for Indiana's gas intrastate pipeline facilities, and is established under IC 8-1-22.5. The Division operates in partnership with the United States Department of Transportation Pipeline and Hazardous Materials Safety Administration ("PHMSA") under a certification agreement. Their mission, to ensure the safe, reliable, and sound operation of Indiana's pipeline transportation system, is accomplished largely through inspections, investigations of pipeline accidents, continuing training, and outreach.

Until 2006, the Pipeline Safety Division's jurisdiction extended only to gas pipeline facilities. Governor Daniels signed House Bill 22 into law in March, 2006. This bill extends the

Division's authority to hazardous liquids and carbon dioxide pipelines. This action allows state oversight of pipelines associated with carbon sequestration, an initiative under development to improve Indiana's position both economically and environmentally. The Division will also regulate other intrastate hazardous liquids pipelines. House Bill 22 also amends IC 8-1-22.5 to incorporate current pipeline safety terminology and standards.

Several provisions included in the Pipeline Safety Act of 2002 continue to impact the State of Indiana. With improved public safety as the intended outcome, additional efforts are being undertaken by pipeline operators and the Commission, to ensure compliance with the law.

The law mandated that all operators of natural gas transmission lines have an integrity management program in place for high consequence areas by December 2004.³⁶ Indiana's intrastate gas companies operate 1,886 miles of transmission pipeline. Not all of these pipelines are located in high consequence areas, as that term is defined in the rule. The impact of a gas pipeline rupture varies based on its size, operating pressure, and proximity to people. The rule requires operators to use these factors, along with other factors, including the calculation of heat-impacted zones, to identify high consequence areas.

For pipelines located in high consequence areas, baseline integrity assessments (determining the current physical condition of pipelines) began in June 2004 and must be completed December 2007 or 2012, depending on the facility's location, pressure, and diameter. Assessments may be made by utilizing in-line inspections (pigging), hydrostatic pressure testing, or direct assessment³⁷.

Gas operators are dedicating significant resources to comply with the regulations and will continue to do so. Costs are incurred for identifying pipeline segments in high consequence areas, setting up a framework for the company's program, conducting a baseline assessment of

³⁶The U.S. Department of Transportation's Office of Pipeline Safety (OPS) issued a final integrity management rule on December 15, 2003, with updates published April 6, 2004, and May 26, 2004.

³⁷ Direct Assessment is a method that utilizes a process to evaluate certain threats (e.g., external corrosion, internal corrosion, and stress corrosion cracking) to a pipeline's integrity. It includes data gathering, indirect and direct examination of the pipeline, and post assessment evaluation.

affected pipelines, conducting periodic assessment and evaluation, evaluating automatic shutoff and remotely controlled valves, data integration, and remedial action. The cost to gas utilities will be dependent partially upon the baseline assessment timeframe, the extent to which Indiana's facilities can be internally inspected, and other factors. The majority of transmission lines operated by Indiana local distribution companies will not accommodate an in-line inspection device and cannot be shut down to conduct a hydro test, so most operators must use direct assessment to determine the condition of the pipe.

Indiana's gas utilities and, in turn, their customers will also be affected by the manner in which interstate gas transmission operators conduct their integrity management programs. Unless adequate time is allowed and the assessment process is carefully managed, flow restrictions can significantly impact gas supply and cost to customers. The potential for critical supply interruptions also exists, as this law applies to interstate transmission companies which serve Indiana utilities. In Indiana there are over 5,000 miles of interstate gas transmission pipelines.

Enforcement of the Integrity Management rule requires additional training for the Commission's Pipeline Safety Division. The Transportation Safety Institute, the training agency within the U.S. Department of Transportation (US DOT), has developed a series of courses which inspectors must complete before conducting Integrity Management inspections.

The Pipeline Safety Division staff conducting these specialized inspections is in the process of completing these courses. Federal protocols are used during the inspection process. Although Indiana's intrastate transmission facilities do not represent the bulk of jurisdictional piping for the Pipeline Safety Division, the nature of the inspections require the Division to dedicate considerable resources to integrity management enforcement, due to the complexity of the regulation. The Pipeline Safety Division has begun its Integrity Management inspections for gas utilities having transmission pipeline facilities.

Work has also begun to determine the appropriate format for integrity management at the distribution level. In Congressional testimony presented in 2004, the US DOT Inspector General

stated that distribution facilities should be subject to integrity management. Congress then directed the US DOT/ PHMSA to respond. The threats associated with gas distribution facilities are different from those which apply to transmission facilities. Additional rules and/or standards for distribution facilities are likely to be the outcome of this effort. Since Indiana operators have over 70,000 miles of distribution facilities, the outcome of this effort will significantly impact those operators and the Pipeline Safety program.

The 2002 Pipeline Safety Act also addresses pipeline outreach programs. Among other things, it requires operators to review and revise existing public education programs concerning gas safety. A National Standard (API Standard RP 1162) has been incorporated by reference into federal pipeline safety regulations. The Pipeline Safety Division must enforce this as part of its inspection process. This Standard sets forth specific requirements regarding the message, methodology, and frequency of communication with target audiences.

In 2005, pipeline operators and Local Distribution Companies formed an association whose purpose is to provide public awareness compliance tools for the industry. The Act also requires the Secretary of Transportation to encourage the adoption of practices set forth in the best practices report entitled “Common Ground”³⁸. Indiana’s Pipeline Safety Division is taking an active role in following through with the requirements of these provisions. It continues to work with state and federal liaisons and the Board, staff, and members of the Indiana Underground Plant Protection Service (“IUPPS”) to encourage the adoption of best practices and involvement in the Common Ground Alliance. The Division intends to take an active role in developing and strengthening Indiana’s underground plant protection laws and damage prevention programs, as third-party damage continues to be the leading cause of pipeline accidents, both statewide and nationwide.

³⁸ The Common Ground study was developed in response to a directive from Congress to the US DOT. The directive required the development of best practices for preventing damage to underground facilities and assuring their safe operation. The result was the comprehensive Common Ground study and the subsequent establishment of the Common Ground Alliance – a non-for profit organization that fosters communication and the adoption of best practices.

The 2002 Act includes additional requirements for Indiana's gas operators, including the establishment of a nationwide standardized 3-digit telephone number system (811) to be used by state one-call programs for "call before you dig" services. On March 10, 2005, the Federal Communications Commission (FCC) designated "811" as the nationwide number for contractors and others to call before conducting excavation activities. The FCC ordered that the number be operational by April 2007. On November 30, 2005 IUPPS submitted a petition to the Commission to act as the administrator of 811 in the State of Indiana. The Commission's Order on this matter was approved on August 23, 2006.

The federal Pipeline Safety program is again up for reauthorization in 2006. It is anticipated that more changes to the Pipeline Safety program will result from federal legislation, especially in the area of the prevention of damage to underground facilities. The Commission's Pipeline Safety Division's performance was rated as "excellent" during the annual inspection of its practices, procedures and records by federal authorities. As a result, the Commission received the maximum allocation available, more than \$220,000, which is equal to nearly half the cost of the program. In addition the Pipeline Safety Division applied for and received a \$36,000 "One Call Grant." The money will be used to promote the prevention of damage to underground utility facilities such as pipelines, telephone cables, electric and water lines in Indiana.

Pipeline Safety Tracker

The cost associated with compliance with the above mentioned law is substantial and recurring. In Cause Nos. 42598 and 42596 approved by the Commission on November 30, 2004 and June 30, 2004, respectively, IGC and SIGECO requested recovery of annual recurring costs related to this issue through a tracking mechanism, which was approved. The Pipeline Safety Tracker works much the same way the GCA process works. IGC and SIGECO are allowed to recover their variable costs associated with compliance the same way they are able to recover the

commodity cost of gas. This tracker is reconciled on a yearly basis and currently IGC and SIGECO are the only LDCs with this tracker.

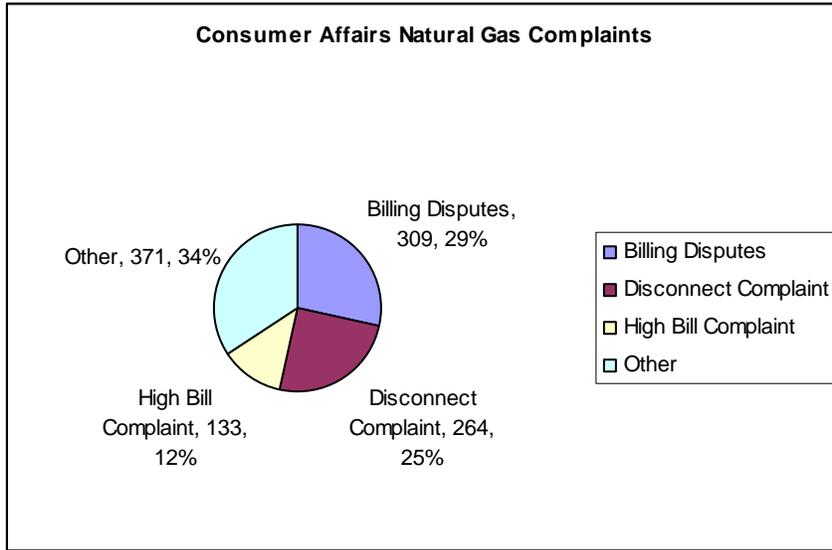
Role of the Commission's Consumer Affairs Division

The Consumer Affairs Division of the Commission mediates disputes between utilities and consumers and deals with consumer education issues. The division reviews and revises the "Rules, Regulations and Standards of Service" for the Indiana utilities. These rules must be followed by the utilities when dealing with their customers.

The division uses information gathered in the complaint handling process to alert the Commission to any consumer problems. If the office discovers a problem developing, it may request an investigation be conducted by the Commission or it may suggest to the utility's customers that they circulate a petition requesting a Commission investigation. The Consumer Affairs Division also attends Commission field hearings to answer any individual consumer questions or complaints that may arise during the hearing process.

The Consumer Affairs Division has had an active year in regards to natural gas complaints. The division received 1,077 natural gas complaints for the fiscal year of July 1, 2005 through June 30, 2006. A majority of these complaints were either billing disputes, complaints about a high monthly bill, or a service disconnect. The chart below displays a distribution of the complaints mentioned.

Chart 3



COMBINED ANALYSIS OF GAS SALES DATA

CITIZENS GAS, INDIANA GAS, NIPSCO, & SIGECO
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<u>Total Sales By Class (1,000 Dth)</u>	<u>2005</u>	<u>2004</u>	<u>2003</u>
Residential	132,774	133,293	141,561
Commercial	56,052	58,745	63,501
Industrial	16,853	18,458	17,441
Other	117	218	5,579
Total	205,796	210,714	228,082
<u>Total Transportation By Class (1,000 Dth)</u>			
Residential	5,419	4,935	4,914
Commercial	13,481	18,242	16,882
Industrial	212,344	212,898	198,991
Other	6,188	4,427	1,871
Total	237,431	240,502	222,658
<u>Total Throughput By Class (1,000 Dth)</u>			
Residential	138,193	138,228	146,474
Commercial	69,532	76,987	80,383
Industrial	229,197	231,356	216,432
Other	6,305	4,645	7,449
Total	443,227	451,216	450,738
<u>Percent Transportation to Throughput</u>			
Residential	3.92%	3.57%	3.35%
Commercial	19.39%	23.69%	21.00%
Industrial	92.65%	92.02%	91.94%
Other	98.14%	95.30%	25.11%
Total	53.57%	53.30%	49.40%

ANALYSIS OF GAS SALES DATA FOR 2003, 2004, & 2005

CITIZENS GAS AND COKE UTILITY
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<u>Revenues By Customer Class</u>	<u>2005</u>	<u>2004</u>	<u>2003</u>
Residential	\$247,190,101	\$214,080,944	\$211,384,956
Commercial & Industrial	139,782,546	119,382,304	120,607,508
Other	17,086,974	26,598,936	2,056,853
Totals	\$404,059,621	\$360,062,184	\$334,049,317
<u>Sales By Customer Class in Dth</u>			
Residential	22,491,466	23,018,806	24,725,447
Commercial & Industrial	14,102,425	14,794,543	16,754,624
Other	-	-	4,328,071
Totals	36,593,891	37,813,349	45,808,142
<u>Revenues Per Dth</u>			
Residential	\$10.9904	\$9.3003	\$8.5493
Commercial & Industrial	9.9120	8.0693	7.1985
Other	-	-	0.4752

INDIANA GAS COMPANY, INC.

<u>Revenues By Customer Class</u>	<u>2005</u>	<u>2004</u>	<u>2003</u>
Residential	\$544,100,167	\$450,041,811	\$439,108,387
Commercial & Industrial	226,139,684	179,265,153	173,232,908
Other	35,124,398	22,778,588	10,348,843
Totals	\$805,364,249	\$652,085,552	\$622,690,138
<u>Sales By Customer Class in Dth</u>			
Residential	44,623,000	44,661,000	48,144,000
Commercial & Industrial	20,387,000	19,673,000	20,773,000
Other	-	-	-
Totals	65,010,000	64,334,000	68,917,000
<u>Revenues Per Dth</u>			
Residential	\$12.1933	\$10.0768	\$9.1207
Commercial & Industrial	11.0923	9.1122	8.3393
Other	-	-	-

NORTHERN INDIANA PUBLIC SERVICE CO.
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<u>Revenues By Customer Class</u>	<u>2005</u>	<u>2004</u>	<u>2003</u>
Residential	\$684,094,445	\$553,581,349	\$584,104,222
Commercial & Industrial	376,496,844	311,811,314	348,415,891
Other	1,018,915	1,463,474	10,979,965
Totals	\$1,061,610,204	\$866,856,137	\$943,500,078
<u>Sales By Customer Class in Dth</u>			
Residential	58,385,412	57,675,495	60,236,514
Commercial & Industrial	34,378,879	38,623,638	38,817,284
Other	112,349	213,256	1,243,411
Totals	92,876,640	96,512,389	100,297,209
<u>Revenues Per Dth</u>			
Residential	\$11.7169	\$9.5982	\$9.6968
Commercial & Industrial	10.9514	8.0731	8.9758
Other	9.0692	6.8625	8.8305

SOUTHERN INDIANA GAS & ELECTRIC CO.
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<u>Revenues By Customer Class</u>	<u>2005</u>	<u>2004</u>	<u>2003</u>
Residential	\$82,665,776	\$73,626,024	\$69,449,674
Commercial & Industrial	40,313,809	33,787,288	33,786,368
Other	42,636	38,603	52,654
Totals	\$123,022,221	\$107,451,915	\$103,288,696
<u>Sales By Customer Class in Dth</u>			
Residential	7,274,568	7,937,903	8,454,811
Commercial & Industrial	4,036,626	4,111,222	4,597,173
Other	4,566	4,881	7,221
Totals	11,315,760	12,054,006	13,059,205
<u>Revenues Per Dth</u>			
Residential	\$11.3637	\$9.2752	\$8.2142
Commercial & Industrial	9.9870	8.2183	7.3494
Other	9.3377	7.9088	7.2918

History of U.S. Gas Market Deregulation

1938 The National Gas Act (NGA)

The NGA created the Federal Power Commission (FPC) to regulate natural gas pipelines (but not wellhead prices). Rapid growth in the 1940s and 1950s outpaced pipeline expansion, which led to price volatility and supply shortages in some areas. Producers requested price caps, but the FPC said it did not believe it had the authority to set them.

1954 The Supreme Court determined the NGA should encompass the regulation of both pipelines and wellhead prices. This was known as the **Phillip's Decision**, and the court held that the primary aim of the NGA was the "protection of consumers against exploitation at the hands of natural gas companies."

This created an industry structure that consisted of price-regulated gas producers, who sold to price-regulated pipelines, who in turn sold gas on to local distribution companies (LDCs). LDCs then sold the gas onto end users (LDCs were regulated by state or local government agencies).

Price volatility was reduced by the Phillip's Decision, but it eventually caused supply shortages - it encouraged consumers to buy relatively cheap fuel but did not provide any incentive to producers to replace reserves.

1978 Natural Gas Policy Act

The Federal Energy Regulatory Commission (FERC) was created out of the old FPC and directed to reform natural gas pricing.

Essentially this was a reversal of the Phillip's decision as it allowed the deregulation of wellhead gas prices.

Production increased dramatically in response to pent-up demand which led to a gas surplus in the 1980s. However, a competitive market failed to develop, mainly due to the role pipelines played in the market. Since pipelines charged consumers enough to cover the cost of what they had to pay producers, there was no incentive for them to select the most competitively priced gas produced.

1985 FERC Order 436

This required pipelines to provide open access to transportation services allowing consumers to negotiate prices directly with producers and contract separately with the pipelines for transportation.

1987 FERC Order 500

Order 500 implemented shared contract costs on take-or-pay (TOP) contracts. Take-or-pay contracts leave the buyer responsible for some portion of the cost even if the product is not provided.

The combination of Orders 436 and 500 allowed producers to balance supplies of gas across production regions - if volume was lacking in one area, but plentiful in another, the producer could arrange to transport the surplus to where it was needed. The transportation system became a mechanism one party owned, but could be accessed by other parties on an equal basis

- hence the concept of open-access. Differences between contract gas shipments and actual consumption left pipelines to make up the difference (balancing) and FERC made balancing a competitive service.

The establishment of gas market firms was also a feature of the 1980s, a direct result of deregulation. These firms, often with no ties to any one gas company, provided an intermediary service between a gas buyer and all other industry segments.

1989 Natural Gas Wellhead Decontrol Act

This act completed the process of deregulating wellhead prices. It required the removal of all price controls on wellhead sales as of Jan. 1, 1993, allowing natural gas prices to be freely set in the market.

1991 Mega-Notice of Proposed Rulemaking (Mega-NOPR)

FERC requested comments from consumers and industry about new ways of structuring gas transportation.

1992 The Restructuring Rule (FERC Order 636)

Order 636 resulted in major restructuring of interstate pipeline operations. The most notable provisions of Order 636 were the separation of sales from transportation services (unbundling), so that customers could select supply and transportation services from any competitor in any quantity and combination, making TOP contracts a thing of the past.

Order 636 successfully impacted the market resulting in increased exploration, pipeline construction, falling prices and increasing profits.

2000 FERC Order 637

Order 637 provided further refinement of the remaining pipeline regulations to address inefficiencies in the capacity release market.

Deregulation in the gas industry has seen the development of commodity products that parallel the evolution of physical natural gas markets. Consumers can negotiate the best terms for supply and transportation to their site and simultaneously negotiate better terms in other markets as a price hedge. The natural gas commodity market is now the most active commodity market on the NYMEX.

The deregulation of the US gas industry has been extremely successful - production has increased, proved reserves have decreased, gas usage is increasing and consumer prices have dropped significantly.

[Editor's note: Circumstances have changed significantly since Platt's wrote this conclusion.]

Source: <http://www.platts.com/usgashistory.shtml>